How Much Can I Borrow?

Generally speaking, if you have a decent credit score, lending institutions will allow you a maximum mortgage payment of up to 40% of your monthly income, minus your monthly debt. That means if your monthly income is (for example) $1,000, the "bank" would allow you have a maximum mortgage payment up to $400 (40% of $1000). This figure assumes that the borrower has no current monthly debt. If the borrower has debt, then the current monthly debt figure is subtracted from the 40% of monthly income. For instance, if the borrower had a $100 car payment each month, it would be subtracted from the $400 to get $300. Something else you will have to remember is that "maximum mortgage payment" also includes property taxes and homeowners insurance. Of the $300 maximum monthly payment, about $100 would be for set aside for taxes and insurance. That leaves us with $200 for principal and interest, so how much is $200 a month in terms of a loan? $200 a month (principal and interest only) is equivalent to about a $30,000, 30-year mortgage, at 7% interest. *(To roughly calculate what your monthly payment would translate to in terms of total mortgage loan, take your monthly payment, not including taxes and insurance, and multiply that number by 150. To get a more precise number, contact your Realtor or mortgage lender.)*

Let's use some realistic numbers: Lets say that there is a young couple with a combined income of $65,000 (Bill & Sue). To find Bill and Sue's monthly income we simply divide their yearly income by 12. $65,000/12 = $5416 per month. We know the "bank" will allow a borrower with decent credit to borrow up to 40% of their monthly income minus their monthly debt. This couple has one car payment of $275.00/month, one student loan of $215.00/moth, and a credit card payment of (minimum payment, not balance) $45.00. Now lets calculate their maximum loan payment: 40% of $5416 = $2,166… $2166 – ($275 + 205 + 45 = $525) = $1641. $1641 is the maximum monthly mortgage payment (including taxes and insurance) that the "bank" will allow Bill & Sue to borrow. Now lets translate how much this is in terms of total mortgage amount (remember this all depends on current interest rates). Roughly $175 of the $1641 will amount to property taxes and insurance. That leaves us with $1466, ($1466 x's 150 = $220,000) which is equivalent to about a $220,000, 30-year mortgage at 7% interest. (This means that the actual loan amount is $220,000, assuming there was no down payment. The sale price could be higher if the borrower was planning on putting the difference on a down payment ($240,000 would be allowed as a purchase price if borrower was going to put $20,000 down).

Does this mean that it's ok to borrow as much as the bank will allow? Probably not. Typically, you don't want to max out the amount the "bank" will lend you (unless you have other sources of income the bank is not seeing or accepting, i.e. self employed). The main reason not to "max" is because it can cause a lot of financial strain. The best way to decide how much you want to spend is to write out a budget and calculate how much in monthly mortgage payment you would feel comfortable with. Obviously, the more you spend the "nicer" the home will be, however, being "house-poor" is no fun either. Remember there are other bills for furniture, utilities, cars, vacations, electronics, Holiday gifts, etc.

Nonetheless, it's good to keep in mind, that your home is often your greatest asset and it will likely rise significantly in value. Overspending on a house is definitely better than overspending on a car or something else, as long as you can make your payments comfortably.

One other thing to consider, when deciding on how much home to buy, is the tax benefits of home ownership. You are allowed to tax-deduct all the interest you pay on your mortgage. If you have a $150,000, 30-year mortgage at 7% you will pay about $10,500 in interest your first year. This comes out to about $2625 in tax savings if you are in the 25% tax bracket, that's $218 a month in tax savings! Also, when you sell a personal residence, the IRS allows you to exclude the first $250,000 ($500,000 for married couples) of profit tax-free! What other tax-shelter do you know that's this good?

Here is an example of a summarized $150,000, 30-year mortgage at 7%.

Monthly Payment: $997.95 (Principal & Interest Only)

End of year totals:		Payments	Interest	Principal	Balance
01	Total	11,975.40	10,451.73	1,523.67	148,476
02	Total	11,975.40	10,341.58	1,633.82	146,842
03	Total	11,975.40	10,223.47	1,751.93	145,090
04	Total	11,975.40	10,096.83	1,878.57	143,212
05	Total	11,975.40	9,961.03	2,014.37	141,197
06	Total	11,975.40	9,815.40	2,160.00	139,037
07	Total	11,975.40	9,659.26	2,316.14	136,721
08	Total	11,975.40	9,491.81	2,483.59	134,237
09	Total	11,975.40	9,312.28	2,663.12	131,574
10	Total	11,975.40	9,119.77	2,855.63	128,719
15	Total	11,975.40	7,927.19	4,048.21	111,029
20	Total	11,975.40	6,236.56	5,738.84	85,951
25	Total	11,975.40	3,839.87	8,135.53	50,401
30	Total	11,979.74	442.26	11,537.48	0.00

Table Key:

Payment = the amount paid out in monthly mortgage payments (in this example the monthly payment is $997.95 not including taxes or insurance, each year the total paid is $11,979.74 for all 30 years)

Interest = the amount of the payments for that year that went towards interest paid on your loan. Your monthly payment is essentially made up of two things: interest & principal. In the early years of a mortgage your payment mainly goes to paying off interest on the loan, later in your loan the reverse happens, and the majority of your payment is going towards the principal balance, this is the nature of an amortized loan.

Principal = the amount of the payments for that year that went towards paying off the principal balance of the loan.

Balance = the amount of the principal balance left over after each year in question. (In this example the loan started with a principal balance of $150,000, after year 1 it was down to $148,476 & after year 30 it is down to $0.00.)

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